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EVEN CENTRAL BANKS NEED ‘CAPITAL’ INFUSION

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Banking, NPAs and RBI

The central bank of a country sits at the pinnacle of its financial system and is mandated with ensuring its stability. From time to time central banks are directly or indirectly involved in shoring up stressed commercial banks with capital infusion. So it may appear odd to suggest that occasionally even the central bank may need some of its own medicine. After all central banks make a surplus from their operations, and indeed pay a dividend to their governments. The puzzle is resolved, however, when we recognise that capital is not only funds but also ideas.

In the context, one of the ideas is related to the role of the central bank in the economy. That this issue is being brought up more than half a century after a central bank was instituted in India need not be interpreted as some weakness in the original conception. An economic arrangement once made cannot be treated as settled for all time to come. This also holds true for central banks, often considered venerable beyond querying. It’s time to reflect on the role of the central bank in India as we hear of impending changes in the higher echelons of the Reserve Bank of India (RBI). The media coverage has focused on differences among some of its functionaries and the government of India but this is besides the point as there has been complete agreement between them on the role of monetary policy. Moreover for about five years now, the government and the RBI have, as though in concert, implemented a deflationary macroeconomic policy via fiscal contraction and monetary tightening, respectively. One of Prime Minister Narendra Modi’s finance ministers claimed credit for the government for having ushered in a period of macroeconomic stability. What this achieved for the economy is a different matter.

Resolving India’s banking crisis

A combination of low inflation and small budget deficits was among the prescriptions of the Washington Consensus that reigned for about a decade and a half from the 1990s. With the implosion of the former Soviet Union and the folding up of its east European satellites, this consensus had, via the clout of the U.S., placed a straitjacket on policy makers in the so-called emerging markets, like India. In that moment of triumph it had been thought that the business cycle, or the oscillating trend in market economies, had been permanently tamed. However, as is so often the case in the life of economies, the cunning of history can derail progress with nary a warning. This arrived in the form of the global financial crisis in 2008, which originating in the U.S. soon spread across the world including India. Growth slowed and unemployment rose. The Obama Administration did not hesitate to intervene drastically, strongly supported by the Federal Reserve Bank. The fiscal deficit rose three-fold and the money supply ballooned. Interestingly, inflation did not rise.

The global financial crisis has led to a substantial re-thinking of macroeconomics. The main revisions are that monetary policy defined by inflation targeting can no longer be treated as the centrepiece of macroeconomic policy, that fiscal policy should be used to stabilise the economy when needed and that financial regulation is a must. The limitation of inflation targeting was understood when the ‘great moderation’, an extended period of low inflation in the west, ended in the financial crisis. It is this that has led to the view that light regulation of the financial sector, as advised by the then Governor of the Federal Reserve Alan Greenspan, can be a recipe for disaster. Finally, it has come to be recognised that assertions of the impotence of fiscal policy may be exaggerated. There could be times when the private sector is held back by the state of the economy. In a recession this would delay recovery. Now fiscal expansion would be necessary. Apart from theoretical demonstration of the stabilising potential of fiscal policy the belief that the explosion of the U.S. fiscal deficit following the crisis actually saved the day has

very likely contributed to the rethinking. The general consensus now is that there should be no going back to the pre-crisis practices of narrow inflation targeting, inflexible fiscal policy, and kid gloves for the financial sector.

It is hoped that the Reserve Bank of India and the economic policy-making establishment will take into account the evolving understanding of macroeconomics globally. It is unfortunate that policymaking in India has been stuck in the past. This would not have mattered if the consequences were benign. The government has taken credit for attainment of macroeconomic stability, defined by low inflation, even as unemployment has been rising since 2011. A continuously declining fiscal deficit has not restrained the RBI leadership from paying hawk-eyed attention to it, constantly lecturing the elected government of the perils of even the slightest deviation from the path of fiscal consolidation, when strictly it is not its business to do so. It should instead focus on putting its own house in order. Two instances of a failure to do so may be mentioned. Ever since we have had de facto inflation targeting in India, from around 2013, the real policy rate has risen very substantially. This has been accompanied by declining borrowing in the formal sector likely affecting investment. Inflation has come down but it was already trending downward, possibly due to the slowing growth. Subsequent inflation reduction has been assisted by the declining price of oil. Evidence of the role of inflation targeting in reducing inflation in India is weak, as summarised in the study 'The dynamics of inflation in India' (Working Paper 485, Centre for Development Studies, Thiruvananthapuram, May 2019) by M. Parameswaran and myself. Ironically, we have had in India the replay of a scene from the global financial crisis where a central bank focusing on inflation loses sight of brewing financial instability. The crisis at IL&FS, with a group company defaulting on its payment obligations jeopardising the interests of hundreds of investors, banks and mutual funds is only a specific case in point. The larger story is of the steady rise in the non-performing assets (NPAs) of banks even as inflation was abating.

A popular reading is that recently the RBI has had to face some pressure exerted by the government's nominees. This may well have been the case. But what we need is not just a central bank that is left to function independently, but also one that is not a slave to some defunct school of thought. It has many mandated functions, among them ensuring an adequate supply of clean currency notes in denominations sought after by the ordinary Indian.

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